A Greek Tragedy

BY DESMOND LACHMAN

New questions about the longer-run viability of the Eurozone.

THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
888 16th Street, N.W.
Suite 740
Washington, D.C. 20006
Phone: 202-861-0791
Fax: 202-861-0790
www.international-economy.com

Groucho Marx famously observed that he would not join a club that would have him as a member. As the Greek economic crisis heats up, one wonders whether Greek policymakers are not thinking the same about Greece's Eurozone membership. Not only does its Eurozone membership seem to be condemning Greece to many years of deep economic recession and deflation. Rather, Greece's present economic travails are now raising serious questions about the longer-run viability of the Eurozone in its present form.

At the root of Greece's present economic crisis is its longstanding failure to remotely live up to its Maastricht Treaty obligations with respect to its public finances. Indeed, from the moment Greece adopted the euro in 2001, the Greek authorities have been engaged in shameless creative budget accounting that evidently misled not only Greece's Eurozone partners but Greek policymakers themselves.

Last October, after a new Greek government took office, markets were rudely reminded about how fast and loose Greece has been with its budget reporting. It was then that George Papandreou, the newly elected Greek prime minister, shocked markets by owning up to the fact that Greece's budget deficit in 2009 would be around 12.75 percentage points of GDP or around double the former officially projected number. It is little wonder that Greece has now become the Eurozone's worst-rated country by the credit rating agencies. It is even less wonder that the Greek government now has to pay the highest interest rates in the Eurozone on its sovereign borrowing.

Greece's budget largesse has clearly put Greece's public finances on an unsustainable path. This is clearly suggested by a budget deficit that is more than four times the Maastricht criteria's 3 percent of GDP limit. It is also underlined by a public debt-to-GDP ratio that is expected to exceed 120 percent by the end of 2010 and to keep rising thereafter. Equally disturbing is the fact that budget profligacy, coupled with inappropriately low ECB interest rates for

---

Desmond Lachman is a Resident Fellow at the American Enterprise Institute.

Greece, has resulted in persistently higher wage and price inflation in Greece than in the rest of the Eurozone. Since adopting the euro in 2001, Greece is estimated to have lost around 30 percentage points in unit labor competitiveness, which has contributed to a widening in its external current account deficit well into the double digits in relation to GDP.

The sad reality is that Greece's domestic and external imbalances have reached such a dimension that their correction within the straightjacket of Eurozone membership will necessarily involve many years of painful deflation and of deep economic recession. Lacking its own currency, Greece cannot restore international competitiveness through currency depreciation. Nor can it use exchange rate devaluation to stimulate its export sector as a means to offset the negative impact on domestic demand of massive budget consolidation.

In the context of a European Central Bank that aims at price stability for the Eurozone, the only way that Greece can regain international competitiveness without currency devaluation is by engineering over time a 20–30 percent drop in domestic wages and prices. This would necessarily involve many years of painfully slow economic growth and very high unemployment. It would also contribute to raising Greece's public debt-to-GDP ratio beyond 150 percent or to a level that Greece could hardly support without a major debt restructuring.

An even surer recipe for many years of a depressed economy and extraordinarily high unemployment levels would be an attempt by the Greek government to reduce its budget deficit over the next three years by the 10 percentage points of GDP needed to bring that deficit into line with the Maastricht criteria. Even if one were to assume that the Keynesian multiplier was only 1.2 for Greece, a 10 percentage points-of-GDP cut in public spending must be expected to directly cause Greece's GDP to contract by 12 percent over that period.

Since tax collections in Greece are around 35 percent of its GDP, were GDP indeed to decline by 12 percent, Greece would lose around 4 percentage points of GDP in tax collections. The net upshot would be that Greece's budget balance would only have improved by 6 percentage points of GDP rather than the desired 10 percentage point of GDP. This would necessitate yet a further round of savage public expenditure cuts that would only further depress the Greek economy.

Taking this line of reasoning to its logical conclusion, it would seem that if Greece is indeed to keep cutting budget spending to meet the Maastricht criteria, while at the same time getting no benefit from a depreciated exchange rate, Greece could very well see its GDP declining by between 15 and 20 percent. In that context, Greek policymakers might want to take a close look at the experience of the hapless Latvia, which is some eighteen months ahead of Greece in the application of a hair-shirt fiscal austerity program under International Monetary Fund supervision to preserve its Euro currency peg. Latvia's GDP has already fallen by 18 percent and the IMF is expecting a further 4 percent decline in 2010.

It is difficult to believe that Greece's social and political fabric would hold together were Greece's recession to be half as deep as that being experienced in Latvia. It is also difficult to believe that a major Greek recession would not result in a wave of household defaults that would shake the Greek banking system to its very roots and that would spark the very capital flight that Greece is seeking to avoid.

Within this somber picture, there is one silver lining for the Greek government. It is the knowledge that the European Central Bank and the European Commission are as fearful of the consequences of a Greek sovereign debt default as is the Greek government itself. For not only would a Greek sovereign default deal a major blow to a still very fragile European banking system. It would also focus the market's full fury on the other highly vulnerable Eurozone members. Spain, Ireland, Portugal, and Italy too all have very troubling public finances and international competitiveness problems

Continued on page 67

The Latvia Example

Greece could very well see its GDP declining by between 15 and 20 percent. In that context, Greek policymakers might want to take a close look at the experience of the hapless Latvia, which is some eighteen months ahead of Greece in the application of a hair-shirt fiscal austerity program under International Monetary Fund supervision to preserve its Euro currency peg. Latvia's GDP has already fallen by 18 percent and the IMF is expecting a further 4 percent decline in 2010.

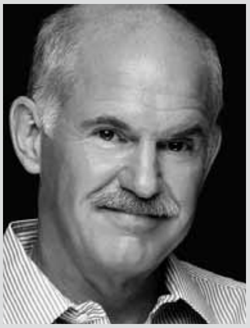
—D. Lachman

From the moment Greece adopted the euro in 2001, the Greek authorities have been engaged in shameless creative budget accounting.

Continued from page 59
that must be expected to raise serious questions in the markets as to whether they would be the next dominoes to fall.

Armed with this knowledge, one can be sure that the Greek government will exert its leverage to extract a bailout from the European Commission so vital to staving off Greece's day of reckoning. Despite all of the European official institutions' present huffing and puffing about Greece's lack of policy commitment, they know that when the chips are down, the very continuation of the Eurozone experiment in its present form is in question.

Sadly, when Greece does get bailed out there will be a basic question that will not be asked by either the Greek government or by the European Commission, whose mutual interest it will be to kick the can forward. It is whether Greece's long-term economic interests are best served by delaying what seems to be Greece's inevitable need to restructure its sovereign debt. Not only will a bailout needlessly put the Greek economy through the wringer and worsen the starting point from which an eventual Greek economic recovery might begin. It will also cruelly saddle Greece with a mountain of official debt that Greece will not be allowed to reschedule. ◆



George Papandreou

Shocked, *Shocked!*

Last October, after a new Greek government took office, markets were rudely reminded about how fast and loose Greece has been with its budget reporting. It was then that **George Papandreou,** the newly elected Greek prime minister, shocked markets by owning up to the fact that Greece's budget deficit in 2009 would be around 12.75 percentage points of GDP or around double the former officially projected number. It is little wonder that Greece has now become the Eurozone's worst-rated country by the credit rating agencies. It is even less wonder that the Greek government now has to pay the highest interest rates in the Eurozone on its sovereign borrowing.

—*D. Lachman*